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No. 02-1367

IN THE

# Supreme Court of the United States

ROBERT R. AND ELSA M. EUSTACE; NICHOLAS E. EUSTACE; ESTATE OF THOMAS A. EUSTACE, DECEASED, VICKY EUSTACE, EXECUTOR; ESTATE OF THOMAS A. EUSTACE, DECEASED, VICKY EUSTACE, INDEPENDENT ADMINISTRATOR AND VICKY EUSTACE; MICHAEL T. EUSTACE; STEVEN A. AND MICHELLE L. DYE,

*Petitioners,*

*v.*

COMMISSIONER OF INTERNAL REVENUE,

*Respondent.*

**ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT**

## REPLY BRIEF

Dated: May 14, 2003

REBECCA M. FOWLER
*Counsel of Record*
JON E. BRIGHTMIRE
DOERNER, SAUNDERS, DANIEL & ANDERSON, L.L.P.
320 South Boston, Suite 500
Tulsa, Oklahoma 74103
(918) 582-1211

*Attorneys for Petitioners*

*(Additional counsel listed on signature page)*

180824

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(800) 274-3321 • (800) 359-6859

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The Petitioner seeks review to settle uncertainty and conflict over taxpayers' entitlement to R&D tax credits. There is no dispute that there are four criteria for entitlement to the tax credit, nor does the Government dispute the meaning or the Petitioner's satisfaction of two of the four criteria.[1] The Government disputes the meaning of the other two criteria — the "discovery" test and the "process of experimentation" test — even though these disputes, so far from showing otherwise, underscore the need for review. The Government further asserts that both this case and a separate Tenth Circuit case (*Tax and Accounting Software Corporation* ("*TAASC*"), also before the Court on a petition for certiorari, No. 02-1291) present the same issue and were correctly decided, even though both courts expressly stated that their decisions were in conflict — another powerful reason to grant review.

## I. The Government's Dispute about the Tax Credit Criteria Underscores the Need for Review.

The Government's dispute of the meaning of the "discovery" and "process of experimentation" tests dramatizes the need for review. This is particularly true because the Government bases its interpretations on assertions that are at odds with the statute, its legislative history, and regulations (which, though not yet formally adopted, have been published with the IRS's express assurance that taxpayers may rely on them for all open returns, and that returns satisfying them will not be challenged).

1. Contrary to the Government's assertion, Applied Systems has never contended that satisfying the test for a research deduction under IRC § 174 automatically satisfies the four requirements of section 41(d). In addition to satisfying the section 174 requirement, the work at issue must also be for the purpose of discovering information that is technological in nature, directed toward the development of a new or improved business component, and achieved through a process of experimentation.

**A. The "Discovery" Test.**

The Government does not dispute that Applied Systems satisfied the "discovery" test as defined by the Treasury Department's proposed regulations. Its only response is that the regulations are only proposed and may be modified, and that if adopted they would replace existing regulations, which are different. Resp. Br. at 4-5 & n.3.

That response ignores the critical feature of the regulations. They are not ordinary "proposed" regulations. Congress itself joined the chorus of criticism of the Treasury Department's belatedly-issued January 2001 "final" regulations,[2] and in response, in February 2001 the Treasury Department suspended the "final" regulations and announced it would issue supplemental regulations.[3] Those proposed supplemental regulations, issued in December 2001, were accompanied by the Treasury Department's and IRS's assurance that taxpayers may rely on the proposed regulations for all open returns,

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2. 66 Fed. Reg. at 66,363 ("Treasury and the IRS have determined that the definition of qualified research set out in [the "final" regulations] does not fully address Congress' concerns regarding the importance of research activities to the U.S. economy.").

3. Notice 2001-19 provided that T.D. 8930, pursuant to which the "final" regulations were issued, would be revised and (except for the rules regarding internal use software, not applicable here) would not be effective earlier than the date when the review of the proposed regulations was complete. The proposed regulations, which were issued on December 26, 2001, remain under review. The "final" regulations, therefore, have been suspended and are not currently in effect. The Government is acutely aware of the tenuous nature of the "final" regulations, for it moved to correct the Seventh Circuit's description of them (*see* Petition at 28 and App. 53a-56a) — yet does not even discuss this issue in its Response.

from any date, and that any tax positions consistent with them would not be challenged. *See* 66 Fed. Reg. at 66,367:

> Notwithstanding this prospective effective date, Treasury and the IRS believe that these rules prescribe the proper treatment of the expenditures they address, and the IRS generally will not challenge return positions consistent with the proposed regulations. Therefore, taxpayers may rely on these proposed regulations until the date final regulations under § 1.41-4 are published in the Federal Register.

The interim "proposed" regulations represent the Government's expressly stated position concerning the credit, and it would be arbitrary and irrational for the Government to take a contrary position for litigation purposes.

The Government's corollary assertion, that the proposed regulations cannot apply because they would replace different, existing regulations (Resp. Br. at 5 n.3), is equally wrong. The statute itself has been a constant for nearly 20 years, so there has been no statutory change, but only an issue of a constant statute's meaning. Because the Treasury Department and IRS instructed taxpayers to follow and rely on the proposed regulations, the "proposed" regulations have already displaced the "final" regulations that were issued in January 2001.[4]

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4. Applied Systems also pointed to, among other things, the language of the legislative history of reenactments of the credit to confirm its interpretation of the original statute. The Government criticizes this reference as reliance on "post-enactment pronouncements by a later Congress as to what an earlier Congress intended." The IRS, however, relied on exactly the same reenactment

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Because those "final" regulations were not yet in effect at the time the work at issue here was performed, and do not apply to open returns, they have absolutely no bearing on the issues before the Court. Even if the "discovery" test applied by the Seventh Circuit (that R&D work must "exceed, expand and refine the principles of computer science" to count as "discovery") were consistent with the January 2001 regulations, those regulations have been suspended, and the Seventh Circuit improperly refused to consider or apply the interim "proposed" regulations, the best indicator of true congressional intent.

**B. The "Process of Experimentation" Test.**

Regarding the "process of experimentation" test, the Government asserts that the tax credit is unavailable for mere "debugging" of software because "debugging" does not constitute "experimentation." This assertion not only misstates what software developers like Applied Systems actually do, but would deny tax credits for any software improvements, even though such improvements are plainly eligible under the statute.

The Government acknowledges, as did the Court of Appeals, that Applied Systems "developed and improved software products" for use by independent insurance agencies. Resp. Br. at 2 (citing Pet. App. 1a, 10a-16a). "Improving" software expressly qualifies for the Section 41 tax credit. The legislative history accompanying the first enactment of the credit provided that the development of "new or significantly

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history when promulgating the proposed regulations and directing that they apply to all open returns. 66 Fed. Reg. at 66,365 (citing the legislative history to the 1986 Act; the Tax and Trade Relief Extension Act of 1998, Public Law 105-277, 112 Stat. 2681-888; and the Tax Relief Extension Act of 1999, Public Law 106-170, 113 Stat. 1860, 1919).

improved computer software" was eligible for the credit. H.R. Rep. No. 97-201, at 114 (1981), 1981-2 C.B. 352, 360.

The Government nevertheless asserts that Applied Systems cannot meet the "process of experimentation" test, because "simply debugging a computer program" is not "experimentation." This assertion is founded on a mistaken conception of the nature of software development and improvement. Debugging is a critical but final task in the development of any software product. Software development begins with the identification of a program's ultimate function or purpose, and continues through the decomposition of that function into components, the creation of a chart of interactions between those components to define the structure of the program, and the embodiment of it all into a written language that the computer can read, all the while attempting to maximize the program's speed and efficiency, minimizing the complexity of operation, and taking into consideration other related factors, such as the memory constraints of the computer on which the program will be run. *Computer Assocs. Int'l, Inc. v. Altai, Inc.*, 982 F.2d 693 (2d Cir. 1992). Applied Systems' improvement of its software during the tax years at issue was not merely the equivalent of proofreading and correcting typos, but (as the trial record showed) included significant new development (e.g., doubling the lines of code in the software), as well as substantive code testing.

Indeed, the Government's position would categorically deny tax credit treatment to software improvement — under the pejorative label "mere debugging" — even though software improvement is expressly comprehended in the statute.

## II. Contrary to the Government's Assertions, the Circuits Expressly Conflict.

The Government denies there is any conflict between the Seventh and Tenth Circuits' articulations of the "discovery" test (despite their obvious differences and those courts' own acknowledgment of a frank conflict), because both courts "reached the same result" — taxpayers lose. *TAASC* Resp. Br. at 5. The Government brushes aside any conflict as "slightly different description[s] of the statutory standards" (Resp. Br. at 5), but in fact the conflict is stark and fundamental. The Tenth Circuit required that a taxpayer not only reach intended technical goals, but also discover information separate from the product itself. The Seventh Circuit flatly rejected that test, but required that a taxpayer's research "exceed, expand and refine the principles of computer science" and not be merely "industrious." *See* Petition at 20. Contrary to the Government's assertion in its briefs here and in *TAASC*, these formulations cannot both be "correct."

The contrary formulations leave taxpayers at sea. A taxpayer cannot know whether it must aim for the "separate" test of the Tenth Circuit or for the "scientific pioneering" test of the Seventh Circuit.

Beyond the conflict with each other, both of these tests conflict with the proposed regulations and legislative history. *See* Petition at 19-20 & n.10 (the requirement that qualified research be "undertaken for the purpose of discovering information which is technological in nature" was intended to distinguish technological research, which may qualify for the research credit, from non-technological research, which does not).

The Government's position, rather than showing legislative, regulatory, and judicial consistency, underscores the need for this Court's review. Congress did not intend that taxpayers would run litigation risk whenever they engage in R&D activity. Instead, Congress expected the Government to articulate clear standards that would apply to all taxpayers — as it has now done in the December 2001 proposed regulations. There is no sound basis for the Government's refusal to apply these regulations here, particularly when the Government has conceded that the regulations reflect the proper interpretation of a statute that has remained unchanged for nearly 20 years. Because of the Government's inconsistent regulatory and litigation positions, only this Court can guarantee that the R&D credit will be fairly and consistently applied.

## CONCLUSION

For the reasons set forth above and in the Petition, the Petitioners respectfully request that the Court grant review.

Dated: May 14, 2003

Respectfully submitted,

ROBERT R. PLUTH, JR.
CATHERINE M. MASTERS
NEIL LLOYD
SCHIFF HARDIN & WAITE
6600 Sears Tower
Chicago, Illinois 60606
(312) 258-5500

REBECCA M. FOWLER
*Counsel of Record*
JON E. BRIGHTMIRE
DOERNER, SAUNDERS, DANIEL & ANDERSON, L.L.P.
320 South Boston, Suite 500
Tulsa, Oklahoma 74103
(918) 582-1211

MARK A. CAMASTA
*Corporate Counsel*
APPLIED SYSTEMS, INC.
200 Applied Parkway
University Park, Illinois 60466
(708) 534-5575

*Attorneys for Petitioners*